

CHAPTER 4:
WASHINGTON STATE GAMBLING COMMISSION
APPROACH TO THE REGULATION OF CHARITABLE AND NONPROFIT
GAMBLING

Since 1973, the Commission's overall approach to regulating the C/NP sector has varied in emphasis. The Commission has developed detailed and refined operational and record-keeping standards for all C/NP licensees. This was an extremely important and positive decision. Without these standards, it would have taken years of effort to assist licensees to develop their own financial and record-keeping systems to the level necessary to conduct gambling activities properly. At the same time, the Commission has attempted to moderate regulatory burdens on the smallest licensees.

The Commission has been remarkably open to authorizing new types of games and operating practices to allow licensees to be more competitive, far more so than many other states. The Commission has been stringent in enforcing the definition of a "bona fide charitable or nonprofit organization." All of these are significant strengths of the Commission's regulatory program.

At times, the Commission has bent over backwards to assist licensees, especially the largest licensees, to be profitable and to comply with income/cash rules. There have been two unintended results of these efforts to address the income and compliance rules. One is that the regulations have been tested and tweaked and changed and modified nine times in twenty years. The other is that the largest licensees are now in compliance but at the expense of dollars for the stated purpose. The required level of income/cash has dropped considerably for the largest licensees since 1996.

The Commission would benefit from a wide-ranging conversation about the current status of the non-gambling C/NP sector generally, and the specific issues pertaining to Washington's C/NP gambling sector, for the purpose of developing a clear and consistent philosophy for regulating the sector.

The discussion should include:

- what "strict control" means in the C/NP sector;
- what "safeguarding the public" means in the context of C/NP gambling and in the charitable/nonprofit environment generally;
- how to balance licensee compliance/ability to offer C/NP gambling activities with assuring significant funds for the stated purpose;
- whether the current method of determining "significant progress" is adequate;
- consideration of specific standards for how large a C/NP organization's gambling operation can be before gambling is considered to be the primary purpose of the organization;
- how the C/NP gambling business model is changing and its implications for regulation;
- the broader C/NP sector's standards for charitable fundraising, to determine which standards might be applicable for the Commission's work in regulating C/NP gambling.

SIX FACTORS REGULATED IN THE CHARITABLE/NONPROFIT SECTOR

The regulation of charitable and nonprofit gambling in Washington State has focused on six aspects of the industry:

1. The nature of a C/NP organization and member
2. Reporting requirements
3. Size (gross receipts)
4. Operating constraints
5. Income and how to calculate it
6. Dollars flowing to the charitable purpose (significant progress)

All of these areas required initial Legislative approval. Over time the Legislature has delegated some areas to the Commission. The Commission handles a number of areas in more detail through the rule-making process, while others have required additional legislative action.

1. **The nature of a charitable/nonprofit (C/NP) organization and member.** When the 1973 authorizing legislation was passed, both the Legislature and the newly-formed Commission assumed that the C/NP organizations already participating in gambling (largely bingo) and the ones who wanted to become licensed, were legitimate organizations. The focus was getting these groups licensed quickly and the Commission took pride in doing so.

This assumption held quite well until the late 1970s and early 1980s when the Commission realized that a number of organizations had been formed largely to benefit individuals and family members through charitable gambling. At that point, the Commission requested, and the Legislature approved (1981), stronger language defining a “bona fide charitable or nonprofit organization” and “bona fide member.”

The definitions included the following requirements:

- Adding the concept of a “bona fide member” as a person accepted for membership, with a specified membership process;
- Requiring not fewer than 15 bona fide members;
- Requiring that the organization have been operating continuously for at least 12 months prior to applying for the license.

This resolved the problems with questionable or bogus organizations seeking to enter the gambling business as charitable/nonprofit organizations.

There was an effort in 1997, in SB 5034, to reduce, from 15 to 7, the minimum number of members that a bona fide charitable or nonprofit organization had to have in order to conduct gambling operations. The bill passed but Gov. Locke vetoed this section on the grounds that the small number of required members (not Board members but members) would “encourage small groups of people to form nonprofit organizations for the primary purpose of engaging in charitable gaming activities, in violation of the gambling code.” (Gov. Locke’s veto message, May 16, 1997.).

2. **Reporting requirements.** The 1973 authorizing legislation gave the Commission broad power to require information in license applications, and to require licensees to perform certain record-keeping and cash-handling procedures.

Recognizing that the handling of money (especially cash) offers the greatest chance for illegal or fraudulent activity, the Commission has consistently strengthened reporting requirements and provided assistance, thorough training and auditing, to licensees who needed help with record-keeping.

Probably the most important decision the Commission made in this regard was to require a single format for record-keeping and reporting for all licensees over a certain level of gross receipts. By standardizing record-keeping and reporting, the Commission avoided the necessity of spending years assisting licensees to develop their own reporting systems to a sophisticated enough level to assure that illegal or fraudulent activities were not occurring.

While these requirements have added complexity to the regulations, they have actually simplified the Commission's work in oversight and audit and undoubtedly helped reduce the number of problems encountered with C/NP licensees over the years.

The other significant decision made by the Commission—in the early 1980s—was to upgrade its audit function and add staff positions for this purpose. The ongoing focus on audits has also helped minimize the number of problems with C/NP licensees.

3. **Size.** The rapid growth of the C/NP sector—most notably Bingo—was one of the most vexing problems addressed by the Commission. Initially, the Commission assumed that the C/NP activities would be small. In fact, the Commission saw “promoting orderly growth” of Bingo as one of its key roles, and set limits on gross receipts as the method for doing so.

This approach worked for the first decade of authorized C/NP gambling. The problem was that by the mid-1980s, the largest operators were bumping up against the \$3.5 million cap on gross receipts. In 1988, the Commission allowed Bingo operators to exceed \$3.5 million in gross receipts if 14% of the overage were given to a charitable cause. In 1988 the Commission added two new license classes over \$4.0 million.

Issues of growth continued to arise, however, and in the mid-1990s, the Commission added four more license classes over \$4.0 million.

Interestingly, nearly all of the focus on size issues has been directed to Bingo. Almost unnoticed, the gross receipts from C/NP punchboards and pulltabs (PB/PT) had increased to \$88.2 million by CY2003, compared to \$119.9 million for Bingo. In other words, PB/PT gross receipts are now \$3.00 for every \$4.00 of Bingo gross receipts.

Further, in CY2003 net receipts for C/NP PB/PT were \$25.1 million, while bingo net receipts were \$29.5 million. Net receipts are gross receipts less prizes.

Even more interestingly, net income (gross receipts less prizes and expenses) for CY2003 showed that PB/PT net income now exceeds Bingo's net income:

Activity	Net Income: CY2003
Bingo	\$6,738,756
C/NP PB/PT	\$8,043,236
Raffles	\$3,242,590

While much of the focus has been on Bingo, PB/PT net income (gross receipts less prizes and expenses) now exceeds Bingo's net income and even Raffles generate nearly half as much net income as Bingo does.

4. **Operating constraints.** In Washington State, the Legislature has the primary role in changing the operating constraints under which C/NP gambling takes place. The Legislature sets the maximum price of a raffle ticket and a punchboard chance and pull tab. The Legislature sets the exceptions to licensure. Thus changes in operating constraints are usually a function of individuals or groups in the C/NP gambling business approaching the Legislature to make changes. Once the Legislature has acted, then the Commission often has a role in writing the implementing details in WAC.

In both Raffles and PB/PT, the Legislature has increased the maximum "price" of a chance several times (1985, 1995, 1997). In each case, gross receipts jumped up after the price was increased.

In 2002, the Legislature passed HB 2918, which authorized bingo operations seven days a week for C/NP licensees.

The Commission has the authority to approve new forms of games offered within Raffles, PB/PT and Bingo. Particularly in the past ten years the Commission has authorized a greater variety of games to be offered. This has been in response to requests to "help level the playing field" between C/NP gambling on the one hand, and commercial and Tribal gambling on the other.

Significant enhancements to games approved by the Commission include:

- 1989: Alternative drawing mechanisms for Raffles (duck races, etc.)
- 1994: Electronic bingo daubers.
- 1996: Keno bingo; progressive jackpots, bonus or "step up" games and bonus pulltabs, carry over jackpots authorized for pulltabs.
- 1998: Linked bingo games; increased PB/PT prizes; non-members can sell Raffle tickets
- 2000: C/NP licensee can sell PB/PT to customers of an adjacent commercial card room; free food and beverages allowed for customers of bingo operators
- 2002: Shared facilities OK'd for bingo operators, also shared management

It is clear that both the Legislature and the Commission have tried quite consistently to provide opportunities for growth and diversification of the games and constraints under which C/NP licensees operate. Conversations with selected other state regulators indicate that Washington has been a leader in this regard.

- 5. Income and how to calculate it.** As activities, especially Bingo, grew in size, the Commission was concerned that sufficient dollars be applied to the organization's stated purpose. However growth in gross receipts did not always translate into growth in net income, in part because Bingo games needed to offer higher prize payouts and nicer amenities (thus more expenses) to sustain or grow their market share. Thus increased gross receipts were often accompanied by lower net income.

This led to a whole series of efforts to define/require net income (see Chapters 5 and 6 (Bingo and Net Income/Return/Adjusted Cash Flow and Appendix D for details). For the first ten years of authorized C/NP gambling, there was not a specific net income requirement. In 1983, prize payouts were limited (by setting limits as a percentage of gross receipts) as a way to stop what was seen as unfair competition by larger games. In 1984, the first net income requirements were set, as a quarterly calculation, on a percentage of gross receipts, for licensees with gross receipts over \$500,000.

In 1985, the calculation was made annual, and set required percentages that had a two percentage point range. The ranges effectively lowered the required net income percentage. Prize payout limits were raised 2-3 percentage points, based on gross receipts. This approach was continued in 1988, but a provision was added allowing the very largest licensees to exceed \$3.5 million in gross receipts, if 14% of the excess was given to a charitable purpose.

In 1989, the net income requirements were reduced by 1 to 3 percentage points (based on Bingo class) across the board for Bingo only and increased for bingo/PB/PT operators. New license classes were added for \$3.5 million and \$4.0 million in gross receipts. Prize payout limits were continued.

In 1990, licensees were permitted to add PB/PT and snack bar net income to their Bingo net income. Because this increased total net income, the net income requirements were 1 to 2.5 percentage points higher than 1989 for Bingo/PB/PT licensees.

In 1993, net income requirements were reduced by one percentage point across the board, for Bingo only and Bingo/PB/PT licensees. Prize payout limits were continued.

In 1996, new license classes up to and exceeding \$6.0 million were added, with 16% net return requirements for the new classes. Class D and Class E gross receipts ranges were changed. Net income was renamed net return and standardized for all operators. Income from sales of food, drink, other and PB/PT) was included and prize payout limits were raised 1 to 2 percentage points. Limits were imposed on Class D bingo (none had existed previously for this class).

In 1999, a moratorium was placed on the downgrading of license classes for licensees who were not meeting the minimum net return requirement, and the net return requirement was reduced by 5 percentage points across the board.

In 2001, the net return approach was scrapped and replaced by “adjusted cash flow” which allowed additional income from raffles, amusement games and related activities to be counted, while dropping amortization and depreciation from the expense side (non-cash items). Adjusted cash flow simplified the calculations by grouping licensees into four “bands” of gross receipts, and requiring a fixed amount to be applied to the stated purpose, plus a percentage of the gross receipts over the minimum. All calculations were to be done on a quarterly basis. The effect of this change was to decrease the dollar requirement.

In 2004, the adjusted cash flow calculations were changed to an annual basis, and the minimum dollar amounts and percentages stayed the same. Previously, the calculation had been done on a “rolling quarter” basis and had been difficult to administer and track.

To the outside observer, this tortuous process seems to represent an extraordinary amount of effort to deal with a business sector that is struggling to meet required profit targets. It is probably time to re-examine the viability of the business model for Bingo, especially the largest bingo operations, and their ability to generate significant net income for their stated purposes over time.

6. **Dollars flowing to the stated purpose (significant progress).** The original rationale for authorizing C/NP gambling was to benefit the stated purposes of the charitable and nonprofit organizations that operate the games. The initial assumption appeared to be that if the activities were authorized, the dollars would flow to the stated purposes.

However because the issues with net income/return/adjusted cash flow have been so difficult, they have raised the companion issue of how much money really does go to the stated purpose. It is one thing to be profitable in gambling, but C/NP gambling organizations are required to be profitable in ways that clearly benefit their stated purposes.

The Commission has tackled this issue in two ways. One has been to focus on the organization’s “stated purpose”—the statement the organization makes on its application for licensure or re-licensure. The other has been to refine, over time, the concept of “significant progress toward the accomplishment of the purposes of the organization.”

The concept of “purpose” was contained in the 1973 authorizing legislation, specifically distinguishing between the organization’s purpose and gambling—in other words, the organization must exist for a purpose other than gambling. The “approved” purposes were spelled out as “charitable, benevolent, eleemosynary, educational, civic, patriotic, political, social, fraternal, athletic, or agricultural.” These were consistent with other RCWs governing charitable and nonprofit organizations.

In 1983, the Commission defined “stated purpose” as “all rules and guidelines set out in the organization’s constitution and/or bylaws which have been approved and are

on file with the commission.” The Commission required that all applicants demonstrate, on initial applications and annually thereafter, the progress they have made toward meeting their stated purpose (WAC 230-04-061). This is the first intersection of “stated purpose” and “progress” in the Commission’s regulatory approach.

The significant progress concept had been included by the 1981 Legislature in ESSB 3307, as part of the tightening up of the definition of a “bona fide charitable or nonprofit organization:

An organization must demonstrate to the commission that it has made significant progress toward the accomplishments of the purposes of the organization during the twelve consecutive month period preceding the date of application for a license or license renewal.

As noted above, this provision was first passed by the Legislature to screen out questionable or bogus organizations seeking to become licensed to provide C/NP gambling.

However, as net income issues arose, the significant progress concept became a key aspect of assuring that licensees did indeed make progress toward their stated purposes on an annual basis.

The “progress toward the stated purpose” language was then revised by the Commission in 1994 and 1996 to include “compliance with all requirements set forth in its bylaws and articles of incorporation” and “actively engages in providing services to the public or its members during the entire period under consideration, and such services directly relate to the stated purpose of the organization.”

Meanwhile, In 1993, the Commission had quantified the meaning of “significant progress” for licensees in Group II and III (at that time the largest licensees) as follows (WAC 230-08-255):

Any charitable or nonprofit organization requesting certification to conduct gambling activities in Group II or Group III, as defined in WAC 230-04-040, must demonstrate that it has made significant progress toward meeting its stated purpose(s) during the period under review. Compliance with the following requirements shall be prima facie evidence that an organization has made significant progress:

- 1) It held elections to select officers at least once in the previous two years;*
- 2) it held a general membership meeting to conduct the business of the organization at least once in the previous two years:*
- 3) it expended at least 60% of the gambling proceeds earned in its most recently completed fiscal accounting year by either directly providing program services or by purchasing capital assets necessary to provide future program services. For purposes of compliance with this subsection, the following provisions and procedures apply:*
 - a) an organization will be deemed to have complied with the requirements of this subsection if:*

- i) *it expends an amount equal to sixty percent or more of gambling proceeds during the current fiscal accounting period providing program services;*
- ii) *it has a formal plan to spend an amount that is equal to or greater than sixty percent of the gambling proceeds earned in the current period and the plan is submitted to the commission as part of its certification application.*

The WAC then specified the conditions under which an organization may be exempt from these requirements. The WAC also specified that no more than 35% of the total amount spent on program services may be for administrative or supporting services (or if more than 50% of the program services are provided indirectly, then the administrative and support limit is 20%), and defined the expense items that could be included within administrative and supporting services.

In 1994, the Commission revised the definition of “significant progress” for all C/NP licensees as follows, making it somewhat less stringent for the smaller licensees:

“Significant progress” means an organization has complied with requirements set forth in its Bylaws and articles of incorporation; has actively engaged in providing services to the public or its members during the entire period under consideration; and the services provided directly relate to the stated purpose of the organization. Such activities will be deemed significant when an organization utilizes a substantial portion of the resources it has available, including net gambling income, for providing services.

The Commission retained the stricter requirements from 1993 for larger licensees, including:

- That they had held elections of officers and membership meetings at least once within the past two years;
- 60% of net gambling income was utilized to provide services to the public;
- A specific formula for computing net gambling income
- Allowing up to 35% for supporting services.

In 1996, the Commission revised the requirements again, adding the concept that the organization must use a “substantial portion of its available resources for providing program services in an efficient manner.” The revised rules made a clear distinction about what the concept of “available resources” did and did not include. The rules also defined “using available resources in an efficient manner” as no more than 35% of total functional expenses used to provide supporting services (defined in a separate section of WAC). There was an exception for program services that were provided indirectly. The rule specified the formula for calculating percentage of functional expenses used to provide supporting services. A waiver provision was included for those licensees who were not in compliance.

The Commission again revised the requirements effective January 1, 1999. The specific requirement for election of officers and a general membership meeting for all licensees were added back (having been dropped except for large licensees in 1996). The reference to using the funds in an “efficient manner” was dropped.

For the larger licensees (now Groups IV and V), the “use of funds” requirement was condensed to say that the organization “has expended at least sixty percent of net gambling income earned in the organization’s most recently completed fiscal year on functional expenses to operate the organization’s programs.” “Functional expenses” were defined as both program and supporting expenses. The calculation formulae were dropped. Waivers were still permitted and the purchase of non-depreciable assets for program purposes were considered part of program services.

In 2002, the Commission revised the significant progress rule again, adding a required “qualification review” process for Group IV and V licensees and an optional qualification review by Commission staff at the request of the Director for Group III licensees. The qualification review was required to occur every three years at a public meeting of the Commission, based on information provided by the licensee.

A question that is not answered by this method of measuring the “significant progress” is whether the dollars being applied to the stated purpose from gambling proceeds are increasing or decreasing from year to year. Since the licensee has the option of applying between 60% and 100% of the gambling proceeds to the stated purpose, the amount could fluctuate widely from year to year just based on the licensee’s decision about percentage to be applied. When that level of flexibility is added to the steady decrease in the net income/return/adjusted cash flow requirements and the declining gross receipts overall, one wonders what the actual amount of money flowing to the stated purpose really is over time. A statistical analysis of four different-sized hypothetical licensees shows that the required amounts have been steadily reduced for the largest licensees.

Finally, the Legislature has responsibility for **tax policy** as it relates to C/NP gambling. The key elements of tax policy are outlined below.

Gambling in Washington State has always been taxed. There is no state tax; all gambling taxes are local taxes. For the most part, the tax proceeds have flowed to local governments.

Charitable and nonprofit licensees felt, from time to time, that the required taxes hindered their ability to meet their net income requirements and made them less competitive. As a result, the C/NP gambling industry approached both the Legislature and local governments for tax relief several times.

Significant Legislative actions on C/NP gambling taxation include:

- 1984: repeal of the pulltab machine tax (these tax proceeds flowed to the Commission, not to local governments.) The tax was replaced by a license fee based on pulltab gross receipts.
- 1999: SB 5745 reduced tax on Bingo and Raffles from 10% to 5% of gross receipts less prizes, effective 1/1/2000.

Significant Commission actions on taxes related to how taxes were reported and counted in a licensee's financial reports.

- 1990: Licensees permitted to show local taxes as a credit on their financial reports, in response to continuing problems with net income/return compliance.
- 2001: Commission deleted local tax credit as part of shift to adjusted cash flow requirements.

In response to financial losses due to Tribal gambling and other competitive pressures, some licensees requested individual local governments to reduce the level of taxation on C/NP receipts.